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Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B06

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Date:

June 20, 2017

In Re:

Legend:

Parent =

Taxpayer =

State A =

State B =

State C =

Commission A =

Commission B =

Department =

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Dear :

This letter responds to the request, filed December 28, 2016, submitted on behalf of Taxpayer for a ruling on the application of the depreciation normalization rules of § 168(i)(9) of the Internal Revenue Code (“Code”) and § 1.167(l)-1 of the Federal Income Tax Regulations (“Regulations”) (together, the “Normalization Rules”) with respect to the computation of accumulated deferred federal income taxes (“ADFIT”) in its calculation of rate base in a rate proceeding.

The representations set out in your letter follow.

Parent is the common parent of a group of affiliated corporations that includes Taxpayer and files a consolidated federal income tax return on a calendar year basis employing the accrual method of accounting. Parent and Taxpayer are incorporated in State A. Parent is currently under the audit jurisdiction of the Large Business and International Division of the Internal Revenue Service.

Taxpayer is a rate-regulated electric utility involved in the production, transmission, distribution and sale of electric energy in State A, State B, and State C. Taxpayer is subject to regulation of rates and other matters in each of the three states in which it operates and by the Commission A for certain operations. Taxpayer is subject to the jurisdiction of Commission B with respect to certain matters. Taxpayer’s most recently-completed Commission B general rate case resulted in an order issued on Date 1, and effective Date 2, granting an increase in rates.

On Date 3, Taxpayer filed a request with Commission B for an increase in revenue recoverable under general base rates in State A. At Taxpayer’s option, this general rate case was based on a forecasted Year 1 test year. Rates will not be final until Year 2, after the close of the forecasted Year 1 test year. Until final rates are implemented, Taxpayer is allowed to charge interim rates. In its filing, Taxpayer also requested an interim rate increase in general base rates. An order of Commission B on Date 4 approved interim rates, which became effective on Date 5. These interim rates are subject to refund at the end of the rate case in Year 2, if final rates determined by Commission B are less than interim rates.

Through this pending rate case proceeding, Taxpayer is also proposing to recover, in base rates, revenue currently subject to recovery under riders. Decisions on recovery of costs in these riders will not be made until Year 2, when the costs proposed to be recovered will be historical.

Taxpayer's request for an interim rate increase was based on the anticipated suspension by Commission B of the effective date of Taxpayer's request for an increase in revenue recoverable under general base rates in State A. Under State A law, interim rates are issued before a full review of costs is completed and are based primarily on the utility's proposed final rates. Under State A law, interim rates are subject to refund or credit to customers, plus interest (the "Interim Rate Refund"). An Interim Rate Refund results if, at the end of the contested case, amounts collected under the interim rate schedule exceed final rates and, if applicable, is typically a one-time refund/credit based on the amount of excess of interim rates over final rates and the time period from the implementation of interim rates until final rates become effective. Taxpayer's final rates are suspended until Date 6, with Commission B's final rate order (subject to reconsideration and other post order procedures) expected on or before Date 6.

On Date 4, Commission B issued an order suspending the effective date of Taxpayer's requested rate increase until Date 7, and referred the matter to the Office to receive testimony, conduct a contested case process, including potential evidentiary hearing, and issue a recommendation to Commission B. Commission B determines final rates, and they can accept, reject, or modify the recommendation from Office.

On Date 4, Commission B also issued an order approving an interim rate increase to the base rates, as modified and subject to the Interim Rate Refund. The interim increase, subject to the Interim Rate Refund, became effective Date 5, and is expected to remain in effect until Commission B makes a final determination on Taxpayer's overall request and final rates become effective. Taxpayer filed a letter on Date 8, agreeing to extend the effective date of Taxpayer's requested rate increase until Date 6.

Taxpayer computed interim rates by applying the proration methodology that is required for future test periods to its ADFIT and proposed that final rates reflect ADFIT proration. Taxpayer also asserted that, whether or not application of the proration formula to final rates is required under the normalization rules, the incremental effect of the revenue requirement on interim rates charged during the test period should not cause or increase the Interim Rate Refund.

In its Order dated Date 4, Commission B set interim rates with ADFIT proration. No party filed an objection to the interim rates set by Commission B. Interim rates are charged from Date 5 through the date in Year 2 when final rates will be implemented.

The Department proposed that ADFIT proration not be reflected in final rates. The Department stated that, because final rates in this proceeding will not go into effect until Year 2, after the forecasted test year, final rates would be based on a then-historical Year 1 test year. Specifically, the Department did not oppose the use of ADFIT proration in setting the interim rates, but proposed that: (1) the level of the Interim Rate Refund for Date 5 through Date 9, be determined without reflecting any ADFIT proration for that period; (2) the level of the Interim Rate Refund for Date 10 until implementation of final rates by Taxpayer be determined without reflecting any ADFIT proration for that period; and (3) federal income tax expense used to set final rates reflect the level of federal income taxes reflected in ADFIT with no proration. Alternatively, the Department recommended that future rate cases rely solely on historical test years.

An evidentiary hearing was conducted by the Office. The report and recommendation of the Office to Commission B is expected on Date 11. Oral arguments before Commission B are expected to occur in Month 1 Year 2, and Commission B's "final" rate order (subject to reconsideration and other post order procedures) is expected on or before Date 6. Final rates are expected to become effective in Month 2 Year 2 and the potential Interim Rate Refund is expected to be paid or credited in Month 3 Year 2.

Taxpayer's revenue requirement for the Year 1 general rate case utilized calendar year, Year 1, as the test year. Amounts estimated for the Year 1 test year include, but are not limited to operating costs (including depreciation expense on Year 1 additions and income tax expense) and rate base items (including plant additions during Year 1, accumulated depreciation reflecting Year 1 depreciation and ADFIT). The Year 1 test year is the basis for both the interim rates (effective beginning on Date 5 and expected to remain in effect until Month 2 Year 2) as well as the final rates (expected to become effective in Month 2 Year 2).

The amounts estimated for the Year 1 test year (including but not limited to operating revenues, costs, plant additions, ADFIT, and other factors affecting the computation of the revenue requirement) are not generally "trued-up" to actual amounts after the end of Year 1 for the determination of final rates. Final rates reflect the resolution of contested items such as the allowed return, recovery of specific categories of operating expenses or the amount of certain operating expenses and inclusion of specific investments and certain costs in rate base. In the case of the Year 1 general rate case, the final rates will also consolidate into base rates the costs and investments historically recovered as part of the riders.

The following rulings are requested on behalf of Taxpayer:

- 1) The computation of ADFIT for purposes of final rates (apart from consideration of an Interim Rate Refund) charged beginning in Month 2 Year 2 without applying the

proration formula rules for future test periods or part-historical and part-future periods under § 1.167(l)-1(h)(6) would not violate the normalization requirements of § 168(i)(9).

2) The computation of ADFIT for purposes of interim rates charged beginning on Date 5, without applying the proration formula rules for part-historical and part-future periods under § 1.167(l)-1(h)(6) would violate the normalization requirements of § 168(i)(9).

3) The future portion of a part-historical and part-future period for purposes of interim rates charged beginning on Date 5, began on Date 5 for purposes of determining the total number of days in the future portion of the period under § 1.167(l)-1(h)(6).

4) The computation of an Interim Rate Refund in Year 2 such that the effects of the proration formula rules under § 1.167(l)-1(h)(6) on interim rates charged in Year 2 are returned in Year 2 (by causing or increasing an Interim Rate Refund) would not violate the normalization requirements of § 168(i)(9).

5) The computation of an Interim Rate Refund in Year 2 such that the effects of the proration formula rules under § 1.167(l)-1(h)(6) on interim rates charged in Year 1 are returned in Year 2 (by causing or increasing an Interim Rate Refund) would violate the normalization requirements of § 168(i)(9).

6) Any reduction in tax expense recoverable in final rates or the computation of any Interim Rate Refund that has the effect of offsetting some or all of the level of revenues resulting from prorated ADFIT that may be required (under the proration formula rules for future test periods or part-historical and part-future periods under § 1.167(l)-1(h)(6)), would violate the normalization requirements of § 168(i)(9).

7) Any reduction in the depreciation expense recoverable in final rates or the computation of any Interim Rate Refund that has the effect of offsetting some or all of the level of revenues resulting from prorated ADFIT that may be required (under the proration formula rules for future test periods or part-historical and part-future periods under § 1.167(l)-1(h)(6)), would violate the normalization requirements of § 168(i)(9).

Law and Analysis

Issues 1, 2, and 3

Section 1.167(l)-1(h)(6) of the Regulations sets forth normalization requirements with respect to public utility property. Under § 1.167(l)-1(h)(6)(i), a taxpayer does not use a normalization method of accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes excluded from the rate base, or treated as cost-free capital, exceeds the amount of the reserve for the period used in determining the taxpayer's ratemaking tax expense. Section 1.167(l)-1(h)(6)(ii) also provides the procedure for

determining the amount of the reserve for deferred taxes to be excluded from rate base or to be included as no-cost capital.

Section 1.167(l)-1(h)(6)(ii) of the Regulations provides that for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under § 1.167(l)-1(h)(6)(i), if solely an historical period is used to determine depreciation for federal income tax expense for ratemaking purposes, then the amount of the reserve account for the period is the amount of the reserve (determined under § 1.167(l)-1(h)(2)) at the end of the historical period. Section 1.167(l)-1(h)(6)(ii) provides that if solely a future period is used for such determination, the amount of the reserve account for the period is the amount of the reserve at the beginning of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during such period.

Section 1.167(l)-1(h)(6)(ii) of the Regulations provides if, in determining depreciation for ratemaking tax expense, a period (the “test period”) is used which is part historical and part future, then the amount of the reserve account for this period is the amount of the reserve at the end of the historical portion of the period and a pro rata amount of any projected increase to be credited to the account during the future portion of the period. The pro rata amount of any increase during the future portion of the period is determined by multiplying the increase by a fraction, the numerator of which is the number of days remaining in the period at the time the increase is to accrue, and the denominator of which is the total number of days in the future portion of the period.

Section 1.167(l)-1(h)(6)(i) of the Regulations makes it clear that the reserve excluded from rate base must be determined by reference to the same period as is used in determining ratemaking tax expense. A taxpayer may use either historical data or projected data in calculating these two amounts, but it must be consistent. As explained in § 1.167(l)-1(a)(1), the rules provided in § 1.167(l)-1(h)(6)(i) are to insure that the same time period is used to determine the deferred tax reserve amount resulting from the use of an accelerated method of depreciation for cost of service purposes and the reserve amount that may be excluded from the rate base or included in no-cost capital in determining such cost of services.

If a taxpayer chooses to compute its ratemaking tax expense and rate base exclusion amount using projected data then it must use the formula provided in § 1.167(l)-1(h)(6)(ii) of the Regulations to calculate the amount of deferred taxes subject to exclusion from the rate base. This formula prorates the projected accruals to the reserve so as to account for the actual time these amounts are expected to be in the reserve. As explained in § 1.167(l)-1(a)(1), the formula in § 1.167(l)-1(h)(6)(ii) provides a method to determine the period of time during which the taxpayer will be treated as having received amounts credited or charged to the reserve account so that the disallowance of earnings with respect to such amounts through rate base exclusion or

treatment as no-cost capital will take into account the factor of time for which such amounts are held by the taxpayer.

The purpose of the proration formula is the same as that of the requirement for consistent periods discussed above: to prevent the immediate flow-through of the benefits of accelerated depreciation to ratepayers. The proration formula stops flow-through by limiting the deferred tax reserve accruals that may be excluded from rate base, and thus the earnings on rate base that may be disallowed, according to the length of time these accruals are actually in the reserve account.

The effectiveness of § 1.167(l)-1(h)(6)(ii) of the Regulations in resolving the timing issue has been limited by its failure to define some key terms. Nowhere does this provision state what is meant by the terms “historical” and “future” in relation to the test period for determining depreciation for ratemaking tax expense. How are these time periods to be measured? One interpretation focuses on the type or quality of the data used in the ratemaking process. According to this interpretation, the historical period is that portion of the test period for which actual data is used, while the portion of the period for which data is estimated is the future period. The second interpretation focuses on when the utility rates become effective. Under this interpretation, the historical period is that portion of the test period before rates go into effect, while the portion of the test period after the effective date of the rate order is the future period.

The first interpretation, which focuses on the quality of the ratemaking data, is an attractive one. It proposes a simple rule, easy to follow and to enforce: any portion of the reserve for deferred taxes based on estimated data must be prorated in determining the amount to be deducted from rate base. The actual passage of time between the date ratemaking data is submitted and the date rates become effective is of no importance. But this interpretation of the regulations achieves simplicity at the expense of precision; in other words, it is overbroad. The proration of all estimated deferred tax data does serve to magnify the benefits of accelerated depreciation to the utility, but this is not the purpose of normalization. Congress was explicit: normalization “in no way diminishes whatever power the [utility regulatory] agency may have to require that the deferred taxes reserve be excluded from the base upon which the utility’s permitted rate of return is calculated.” H.R. Rep. No. 413, 91st Cong., 1st Sess. 133 (1969).

In contrast, the second interpretation of § 1.167(l)-1(h)(6)(ii) of the Regulations is consistent with the purpose of normalization, which is to preserve for regulated utilities the benefits of accelerated depreciation as a source of cost-free capital. The availability of this capital is ensured by prohibiting flow-through. But whether or not flow-through can even be accomplished by means of rate base exclusions depends primarily on whether, at the time rates become effective, the amounts originally projected to accrue to the deferred tax reserve have actually accrued.

If rates go into effect before the end of the test period, and the rate base reduction is not prorated, the utility commission is denying a current return for accelerated depreciation benefits the utility is only projected to have. This procedure is a form of flow-through, for current rates are reduced to reflect the capital cost savings of accelerated depreciation deductions not yet claimed or accrued by the utility. Yet projected data is often necessary in determining rates, since historical data by itself is rarely an accurate indication of future utility operating results. Thus, the regulations provide that as long as the portion of the deferred tax reserve based on truly projected (future estimated) data is prorated according to the formula in § 1.167(l)-1(h)(6)(ii) of the Regulations, a regulator may deduct this reserve from rate base in determining a utility's allowable return. In other words, a utility regulator using projected data in computing ratemaking tax expense and rate base exclusion must account for the passage of time if it is to avoid flow-through.

But if rates go into effect after the end of the test period, the opportunity to flow through the benefits of future accelerated depreciation to current ratepayers is gone, and so too is the need to apply the proration formula. In this situation, the only question that is important for the purpose of rate base exclusion is the amount in the deferred tax reserve, whether actual or estimated. Once the future period, the period over which accruals to the reserve were projected, is no longer future, the question of when the amounts in the reserve accrued is no longer relevant (at the time the new rate order takes effect, the projected increases have accrued, and the amounts to be excluded from rate base are no longer projected but historical, even though based on estimates).

Taxpayer's computation of ADFIT for purposes of final rates occurs after the end of the test period on which those amounts are based. The calculation is determined by reference to a purely historical period. Thus, the test period is one that occurs prior to the effective date of the rates which result from the computation. Accordingly, the computation of ADFIT for purposes of final rates employs an historical test period and is not subject to the proration formula rules under § 1.167-1(h)(6) of the Regulations; there is no need to follow the proration formula rules designed for future test periods or part-historical and part-future periods to calculate the differences between Taxpayer's projected ADFIT balance and the actual ADFIT balance during the period.

In contrast, Taxpayer calculates its ADFIT for purposes of interim rates charged beginning on Date 5. The rate is based on costs Taxpayer projects it will incur during the test year, Year 1. Rates go into effect as of Date 5. Therefore, rates go into effect before the end of the test period. Accordingly, the test period for Taxpayer's interim rates is a future test period, subject to the proration formula rules under § 1.167-1(h)(6) of the Regulations, and Taxpayer is required to apply the proration formula rules for part-historical and part-future periods to calculate the differences between Taxpayer's projected ADFIT balance and the actual ADFIT balance during that period.

The revenue requirement for the interim rates, subject to refund, became effective Date 5, pursuant to a Commission B order issued on Date 4. The interim rates were based on a calendar year, Year 1, test year, but excluded costs and return associated with public utility property recovered through riders. Rate base for the Year 1 test year was computed as an average rate base. The average ADFIT amount was based on a simple average based on the estimate of ADFIT as of the beginning of the Year 1 test year and the estimate of ADFIT as of the end of the Year 1 test year, as prorated. The future portion of a part-historical and part-future period for purposes of interim rates charged began on Date 5, for purposes of determining the total number of days in the future portion of the period under § 1.167(l)-1(h)(6) of the Regulations.

Issues 4 and 5

The interim rates set by the order of Commission B dated Date 5, are charged during the pendency of the rate case until final rates are implemented (expected to be in Month 2 Year 2). A separate set of interim rates are not determined for Year 2. Once final rates are determined, the Interim Rate Refund is calculated, based on the difference between final rates and interim rates for the period during which interim rates have been collected.

The determination of the Interim Rate Refund includes the question of how to calculate the Interim Rate Refund for interim rates collected in Year 2 (that is, after the test year is completed.) Issue # 4 focuses on the calculation of the Interim Rate Refund based on the difference between final rates and the interim rates that are charged starting in Month 4 Year 2 and collected until final rates are implemented.

Similarly, the determination of the Interim Rate Refund includes the question of how to calculate the Interim Rate Refund for interim rates collected in Year 1. Issue # 5 focuses on the calculation of the Interim Rate Refund based on the difference between final rates and the interim rates that were charged during the Year 1 test year.

Once the future portion of the part-historical and part-future test year is no longer future (for example, for rates charged after the end of the test year), the question of when the amounts in the reserve for deferred taxes accrued is no longer relevant. Specifically, while interim rates are charged in Year 2, the projected Year 1 ADFIT increases have accrued, and the amounts to be excluded from rate base are no longer projected but historical, even though based on estimates. Thus, the purpose of the proration formula has been accomplished and associated prevention of flowthrough accounting has been avoided as of the beginning of Year 2 (that is, after the end of the Year 1 test year).

Commission B will use the Interim Rate Refund to adjust Taxpayer's interim rates charged after the end of the test year. Commission B is not adjusting interim rates but is instead using the approach to reflect the Year 2 incremental effects of the proration

formula on the revenue requirement on which interim rates are based in the Interim Rate Refund. Accordingly, the computation of an Interim Rate Refund in Year 2 such that the effects of the proration formula rules under § 1.167(l)-1(h)(6) of the Regulations on interim rates charged in Year 2 are returned in Year 2 (by causing or increasing an Interim Rate Refund) would not violate the normalization requirements of § 168(i)(9) of the Code.

The issue of whether it is appropriate to permit the Interim Rate Refund to reverse the effects of the proration formula on interim rates charged *during* the Year 1 test year differs from the issue of the proration formula to interim rates charged *after* the Year 1 test year. The purpose of the proration formula is to prevent the immediate flow-through of the benefits of accelerated depreciation to ratepayers. The proration formula stops flow-through by limiting the deferred tax reserve accruals that may be excluded from rate base, and thus the earnings on rate base that may be disallowed, according to the length of time these accruals are actually in the reserve account. To permit the effects of the proration formula on interim rates charged during the Year 1 test year to be reversed in a subsequent phase of the ratemaking would be economically equivalent to not applying the proration formula in the first place.

Accordingly, the computation of an Interim Rate Refund in Year 2 such that the effects of the proration formula rules under § 1.167(l)-1(h)(6) of the Regulations on interim rates charged in Year 1 are returned in Year 2 (by causing or increasing an Interim Rate Refund) would violate the normalization requirements of § 168(i)(9) of the Code.

Issues 6 and 7

Regarding issues six and seven, reduction of Taxpayer's tax expense or depreciation expense recoverable in final rates or the computation of any Interim Rate Refund that has the effect of offsetting some or all of the level of revenues resulting from prorated ADFIT that may be required would, in effect, flow through the tax benefits of accelerated depreciation deductions to rate payers. This is so even if the intent of such reduction is not specifically to mitigate the effects of the normalization rules. In general, taxpayers may not adopt any accounting treatment that directly or indirectly circumvents the normalization rules. See generally, § 1.46-6(b)(2)(ii) (In determining whether, or to what extent, the investment tax credit has been used to reduce cost of service, reference shall be made to any accounting treatment that affects cost of service); Rev. Proc. 88-12, 1988-1 C.B. 637, 638 (It is a violation of the normalization rules for taxpayers to adopt any accounting treatment that, directly or indirectly flows excess tax reserves to ratepayers prior to the time that the amounts in the vintage accounts reverse).

Accordingly, any reduction in tax expense or depreciation expense recoverable in final rates or the computation of any Interim Rate Refund that has the effect of offsetting

some or all of the level of revenues resulting from prorated ADFIT in setting interim rates that may be required (under the proration formula rules for future test periods or part-historical and part-future test periods under § 1.167(l)-1(h)(6) of the Regulations), would violate the normalization requirements of § 168(i)(9) of the Code.

Therefore, we rule as follows:

- 1) The computation of ADFIT for purposes of final rates (apart from consideration of an Interim Rate Refund) charged beginning in Month 2 Year 2 without applying the proration formula rules for future test periods or part-historical and part-future periods under § 1.167(l)-1(h)(6) would not violate the normalization requirements of § 168(i)(9).
- 2) The computation of ADFIT for purposes of interim rates charged beginning on Date 5, without applying the proration formula rules for part-historical and part-future periods under § 1.167(l)-1(h)(6) would violate the normalization requirements of § 168(i)(9).
- 3) The future portion of a part-historical and part-future period for purposes of interim rates charged beginning on Date 5, began on Date 5 for purposes of determining the total number of days in the future portion of the period under § 1.167(l)-1(h)(6).
- 4) The computation of an Interim Rate Refund in Year 2 such that the effects of the proration formula rules under § 1.167(l)-1(h)(6) on interim rates charged in Year 2 are returned in Year 2 (by causing or increasing an Interim Rate Refund) would not violate the normalization requirements of § 168(i)(9).
- 5) The computation of an Interim Rate Refund in Year 2 such that the effects of the proration formula rules under § 1.167(l)-1(h)(6) on interim rates charged in Year 1 are returned in Year 2 (by causing or increasing an Interim Rate Refund) would violate the normalization requirements of § 168(i)(9).
- 6) Any reduction in tax expense recoverable in final rates or the computation of any Interim Rate Refund that has the effect of offsetting some or all of the level of revenues resulting from prorated ADFIT that may be required (under the proration formula rules for future test periods or part-historical and part-future periods under § 1.167(l)-1(h)(6)), would violate the normalization requirements of § 168(i)(9).
- 7) Any reduction in the depreciation expense recoverable in final rates or the computation of any Interim Rate Refund that has the effect of offsetting some or all of the level of revenues resulting from prorated ADFIT that may be required (under the proration formula rules for future test periods or part-historical and part-future periods under § 1.167(l)-1(h)(6)), would violate the normalization requirements of § 168(i)(9).

These rulings are based on the representations submitted by Taxpayer and are only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above. This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely,

Patrick S. Kirwan
Chief, Branch 6
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

cc: